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July 11, 2005

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Floor
Boston, Massachusetts 02110

Re: Southern Union Company, D.T.E. 05-38

Dear Secretary Cottrell:

Enclosed herewith are the responses of New England Gas Company to RR-DTE-1 and RR-DTE-2 in the above-referenced proceeding.

Please do not hesitate to contact me if you have any questions or if I can provide you with any additional information. Thank you for your attention to this matter.

Sincerely,

Cheryl M. Kimball

Enclosures

cc: Elizabeth A. Cellucci, Hearing Officer

Record Request DTE-1

Please provide a copy of the GAAP standard applicable to the accounting for the stock dividend.

Response

Attached is the statement of the Financial Accounting Standards Board addressing "Stock Dividends and Stock Split-ups."

Browse Location: United States\Financial Accounting Standards Board (FASB)\Original Pronouncements\Accounting Research Bulletins (ARB)\ARB 43: Restatement and Revision of Accounting Research Bulletins
Publish Date: 05 January, 2005

Chapter 7: CAPITAL ACCOUNTS

Section A — Quasi-Reorganization or Corporate Readjustment

(Amplification of Institute Rule No. 2 of 1934)

1. A rule was adopted by the Institute in 1934 which read as follows:

> "Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization." [1]

2. Readjustments of the kind mentioned in the exception to the rule fall in the category of what are called quasi-reorganizations. This section does not deal with the general question of quasi-reorganizations, but only with cases in which the exception permitted under the rule of 1934 is availed of by a corporation. Hereinafter such cases are referred to as readjustments. The problems which arise fall into two groups: (a) what may be permitted in a readjustment and (b) what may be permitted thereafter.

Procedure in Readjustment

3. If a corporation elects to restate its assets, capital stock, and surplus through a readjustment and thus avail itself of permission to relieve its future income account or earned surplus account of charges which would otherwise be made thereagainst, it should make a clear report to its shareholders of the restatements proposed to be made, and obtain their formal consent. It should present a fair balance sheet as at the date of the readjustment, in which the adjustment of carrying amounts is reasonably complete, in order that there may be no continuation of the circumstances which justify charges to capital surplus.

4. A write-down of assets below amounts which are likely to be realized thereafter, though it may result in conservatism in the balance sheet at the readjustment date, may also result in overstatement of earnings or of earned surplus when the assets are subsequently realized. Therefore, in general, assets should be carried forward as of the date of readjustment at fair and not unduly conservative amounts, determined with due regard for the accounting to be employed by the company thereafter. If the fair value of any asset is not readily determinable a conservative estimate may be made, but in that case the amount should be described as an estimate and any material difference arising through realization or otherwise and not attributable to events occurring or circumstances arising after that date should not be carried to income or earned surplus.

5. Similarly, if potential losses or charges are known to have arisen prior to the date of readjustment but the amounts thereof are then indeterminate, provision may properly be made to cover the maximum *probable* losses or charges. If the amounts provided are subsequently found to have been excessive or insufficient, the difference should not be carried to earned surplus nor used to offset losses or gains originating after the readjustment, but should be carried to capital surplus.

6. When the amounts to be written off in a readjustment have been determined, they should be charged first against earned surplus to the full extent of such surplus; any balance may then be charged against capital surplus. A company which has subsidiaries should apply this rule in such a way that no consolidated earned surplus survives a readjustment in which any part of losses has been charged to capital surplus.

7. If the earned surplus of any subsidiaries cannot be applied against the losses before resort is had to capital surplus, the parent company's interest in such earned surplus should be regarded as capitalized by the readjustment just as surplus at the date of acquisition is capitalized, so far as the parent is concerned.

8. The effective date of the readjustment, from which the income of the company is thereafter determined, should be as near as practicable to the date on which formal consent of the stockholders is given, and should ordinarily not be prior to the close of the last completed fiscal year.

Procedure after Readjustment

9. When the readjustment has been completed, the company's accounting should be substantially similar to that appropriate for a new company.

10. After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance. The dating of earned surplus following a quasi reorganization would rarely, if ever, be of significance after a period of 10 years. There may be exceptional circumstances in which the discontinuance of the dating of earned surplus could be justified at the conclusion of a period less than 10 years.

11. Capital surplus originating in such a readjustment is restricted in the same manner as that of a new corporation; charges against it should be only those which may properly be made against the initial surplus of a new corporation.

12. It is recognized that charges against capital surplus may take place in other types of readjustments to which the foregoing provisions would have no application. Such cases would include readjustments for the purpose of correcting erroneous credits made to capital surplus in the past. In this statement the committee has dealt only with that type of readjustment in which either the current income or earned surplus account or the income account of future years is relieved of charges which would otherwise be made thereagainst.

Section B — Stock Dividends and Stock Split-ups

1. The term *stock dividend* as used in this section refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property which the board of directors deems necessary or desirable to retain in the business.

2. The term *stock split-up* as used in this chapter refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares.

3. This chapter is not concerned with the accounting for a distribution or issuance to shareholders of (a) shares of another corporation theretofore held as an investment, or (b) shares of a different class, or (c) rights to subscribe for additional shares or (d) shares of the same class in cases where each shareholder is given an election to receive cash or shares.

4. The discussion of accounting for stock dividends and split-ups that follows is divided into two parts. The first deals with the problems of the recipient. The second deals with the problems of the issuer.

As to the Recipient

5. One of the basic problems of accounting is that of income determination. Complete discussion of this problem is obviously beyond the scope of this chapter. Basically, income is a realized gain and in accounting is recognized, recorded, and stated in accordance with certain principles as to time and amount.

6. If there is an increase in the market value of his holdings, such unrealized appreciation is not income. In the case of a stock dividend or split-up, there is no distribution, division, or severance of corporate assets. Moreover, there is nothing resulting therefrom that the shareholder can realize without parting with some of his proportionate interest in the corporation.

7. The foregoing are important points to be considered in any discussion of the accounting procedures to be followed by the recipient of a stock dividend or split-up since many arguments put forward by those who favor recognizing stock dividends as income are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation, and prior to its distribution to the shareholder; the acceptance of such arguments would require the abandonment of the *separate entity* concept of corporation accounting.

8. The question as to whether or not stock dividends are income has been extensively debated; the arguments pro and con are well known. [1] The situation cannot be better summarized, however, than in the words approved by Mr. Justice Pitney in *Eisner v. Macomber*, 252 U.S. 189, wherein it was held that stock dividends are not income under the Sixteenth Amendment, as follows:

> "A stock dividend really takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. Its property is not diminished and their interests are not increased ... the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interests that the original shares represented before the issue of the new ones."

9. Since a shareholder's interest in the corporation remains unchanged by a stock dividend or split-up except as to the number of share units constituting such interest, the cost of the shares previously held should be allocated equitably to the total shares held after receipt of the stock dividend or split-up. When any shares are later disposed of, a gain or loss should be determined on the basis of the adjusted cost per share.

As to the Issuer

Stock dividends

10. As has been previously stated, a stock dividend does not, in fact, give rise to any change whatsoever in either the corporation's assets or its respective shareholders' proportionate interests therein. However, it cannot fail to be recognized that, merely as a consequence of the expressed purpose of the transaction and its characterization as a *dividend* in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received. Furthermore, it is to be presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, consequently, the market value of the shares previously held remains substantially unchanged. The committee therefore believes that where these circumstances exist the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except to the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions.

11. Where the number of additional shares issued as a stock dividend is so great that it has, or may reasonably be expected to have, the effect of materially reducing the share market value, the committee believes that the implications and possible constructions discussed in the preceding paragraph are not likely to exist and that the transaction clearly partakes of the nature of a stock split-up as defined in paragraph 2. Consequently, the committee considers that under such circumstances there is no need to capitalize earned surplus, other than to the extent occasioned by legal requirements. It recommends, however, that in such instances every effort be made to avoid the use of the word *dividend* in related corporate resolutions, notices, and announcements and that, in those cases where because of legal requirements this cannot be done, the transaction be described, for example, as a *split-up effected in the form of a dividend.*

12. In cases of closely-held companies, it is to be presumed that the intimate knowledge of the corporations' affairs possessed by their shareholders would preclude any such implications and possible constructions as are referred to in paragraph 10. In such cases, the committee believes that considerations of public policy do not arise and that there is no need to capitalize earned surplus other than to meet legal requirements.

13. Obviously, the point at which the relative size of the additional shares issued becomes large enough to materially influence the unit market price of the stock will vary with individual companies and under differing market conditions and, hence, no single percentage can be laid down as a standard for determining when capitalization of earned surplus in excess of legal requirements is called for and when it is not. However, on the basis of a review of market action in the case of shares of a number of companies having relatively recent stock distributions, it would appear that there would be few instances involving the issuance of additional shares of less than, say, 20% or 25% of the number previously outstanding where the effect would not be such as to call for the procedure referred to in paragraph 10.

14. The corporate accounting recommended in paragraph 10 will in many cases, probably the majority, result in the capitalization of earned surplus in an amount in excess of that called for by the laws of the state of incorporation; such laws generally require the capitalization only of the par value of the shares issued, or, in the case of shares without par value, an amount usually within the discretion of the board of directors. However, these legal requirements are, in effect, minimum requirements and do not prevent the capitalization of a larger amount per share.

Stock Split-ups

15. Earlier in this chapter a stock split-up was defined as being confined to transactions involving the issuance of shares, without consideration moving to the corporation, for the purpose of effecting a reduction in the unit market price of shares of the class issued and, thus, of obtaining wider distribution and improved marketability of the shares. Where this is clearly the intent, no transfer from earned surplus to capital surplus or capital stock account is called for, other than to the extent occasioned by legal requirements. It is believed, however, that few cases will arise where the aforementioned purpose can be accomplished through an issuance of shares which is less than, say, 20% or 25% of the previously outstanding shares.

16. The committee believes that the corporation's representations to its shareholders as to the nature of the issuance is one of the principal considerations in determining whether it should be recorded as a stock dividend or a split-up. Nevertheless, it believes that the issuance of new shares in ratios of less than, say, 20% or 25% of the previously outstanding shares, or the frequent recurrence of issuances of shares, would destroy the presumption that transactions represented to be split-ups should be recorded as split-ups.

Three members of the committee, Messrs. Knight, Calkins, and Mason, assented with qualification, and one member, Mr. Wilcox, dissented to adoption of section B of chapter 7.

Mr. Knight assents with the qualification that he believes the section should recognize the propriety of treating as income stock dividends received by a parent from a subsidiary. He believes the section should have retained from the original Bulletin No. 11 the statement, "It is recognized that this rule, under which the stockholder has no income until there is a distribution, division, or severance, may require modification in some cases, or that there may be exceptions to it, as, for instance, in the case of a parent company with respect to its subsidiaries. . . ."

Messrs. Calkins and Mason approve part one, but believe part two is inconsistent therewith in that the former concludes that a stock dividend is not income to the recipient while the latter suggests accounting procedures by the issuer based on the assumption that the shareholder may think otherwise. They believe it is inappropriate for the corporate entity to base its accounting on considerations of possible shareholder reactions. They also believe that part two deals with matters of corporate policy rather than accounting principles and that the purpose sought to be served could be more effectively accomplished by appropriate notices to shareholders at the time of the issuance of additional shares.

Mr. Wilcox dissents from the recommendations made both as to the recipient and as to the issuer. He believes that, with proper safeguards, stock dividends should be regarded as marking the point at which corporate income is to be recognized by shareholders, and denies that the arguments favoring this view are in substance arguments for the recognition of corporate income as income to the shareholder as it accrues to the corporation. He believes that the arguments regarding severance and maintenance of proportionate interest are unsound, and cannot logically be invoked as they are in this section, since they are widely ignored with respect to distributions of securities other than common stock dividends. Mr. Wilcox believes the recommendations as to the issuer are inconsistent with the rest of the section, involve arbitrary distinctions, hamper or discourage desirable corporate actions, result in meaningless segregation in the proprietorship section of balance sheets, and serve no informative purpose which cannot be better served by explanatory disclosures. He therefore also dissents from the omission of requirements for information and disclosures which were contained in the original Bulletin No. 11 issued in September, 1941.

Section C—Business Combinations

[Section C has been deleted. See Status page.]

is known as the declaration date, and the announcement includes the holder-of-record date and the payment date. A typical announcement might read: "On July 18, 1992, the directors of ABC Corporation met and declared a dividend payment of $1 per share, payable to shareholders of record on August 25, 1992, with payment to be made on October 1, 1992."

[a] Regular Dividends. The vast majority of dividend-paying companies distribute earnings to common shareholders at regular intervals, usually quarterly. Companies that establish regular dividend payment policies are generally reluctant to reduce or omit the dividend for fear that such an action will be perceived negatively by investors. Therefore, regular dividends tend to become viewed by management as a fixed disbursement and will rarely be cut except in the most serious circumstances.

[b] Special Dividends. Once earnings for an entire fiscal year are known, a company may elect to make a distribution in the form of a onetime special or extra dividend. The onetime payment may be used to share higher than expected earnings with stockholders. The irregular occurrence of this type of dividend alerts shareholders that the payment should be treated as a onetime event and not a regular dividend. This tactic permits the company to convey some good news and distribute earnings to shareholders without increasing the regular dividend to a level that may not be sustainable. A company that routinely pays no regular dividend may occasionally choose to pay a special dividend.

[c] Stock Dividends. A stock dividend is a noncash distribution and is similar to a stock split in that it increases the number of shares outstanding without affecting the wealth or the ownership interest of the current shareholders. For example, in a 10 percent stock dividend, the owner of 100 shares of stock will receive an additional 10 shares at no cost. The shareholder now owns 110 shares, but earnings-per-share and price-per-share figures have decreased in proportion to the dividend, effectively having no impact on the value of the holdings. Despite the similar effects of stock dividends and splits, the events are treated differently on the balance sheet. Figure E3-1 illustrates the accounting treatment of the two transactions.

[2] Share Repurchase

As an alternative to paying a cash dividend, a company may choose to distribute earnings to its shareholders by repurchasing its own shares. A share repurchase is often chosen when management believes that the stock market has undervalued its shares or that its shares are the company's best currently available investment opportunity. Share repurchases have also been used by corporate management to defend against unwanted takeovers. In many cases, a share repurchase will increase the share price of the remaining outstanding shares. This type of distribution effectively distributes cash to shareholders in the form of capital gains rather than dividends.

[3] Dividend Yield

The dividend yield is the annual dividend payment divided by the stock price. Usually, dividend yield is computed at a point in time by annualizing the current quarterly

FIGURE E3-1

Accounting for Stock Dividend Versus Stock Split

Before a Stock Split or a Stock Dividend	
Common stock (3,000,000 shares authorized, 2,500,000 shares outstanding, $1 par)	$ 2,500,000
Additional paid-in capital	5,000,000
Retained earnings	77,500,000
Total common stockholders' equity	$85,000,000
After a Two-For-One Stock Split	
Common stock (6,000,000 shares authorized, 5,000,000 shares outstanding, $0.50 par)	$ 2,500,000
Additional paid-in capital	5,000,000
Retained earnings	77,500,000
Total common stockholders' equity	$85,000,000
After a 20% Stock Dividend	
Common stock (3,000,000 shares authorized, 3,000,000 shares outstanding, $1 par)[a]	$ 3,000,000
Additional paid-in capital[b]	44,500,000
Retained earnings[b]	37,500,000
Total common stockholders' equity	$85,000,000

[a] Shares outstanding are increased by 20 percent, from 2.5 million to 3 million.

[b] A transfer equal to the market value of the new shares ($80 per share) is made from the retained earnings account to the additional paid-in capital and common stock accounts:

Transfer = (2,500,000 shares)(0.2)($80) = $40,000,000

Of this $40 million, ($1 par)(500,000 shares) = $500,000 goes to common stock and $39.5 million to paid-in capital.

dividend and dividing by the current stock price; that is, if the current quarterly dividend is 25 cents and the stock price is $20, the indicated annual dividend is $1 and the dividend yield is 5 percent per annum.

[4] Dividend Payout Ratio

The dividend payout ratio is the proportion of earnings the company pays to shareholders in the form of dividends and is usually calculated on a per-share basis. For example, if earnings are $4 per share for the year and dividends are $1 per share for the year, the payout ratio equals 25 percent. Although a company may elect to pay out a constant percentage of earnings, this policy is rarely selected by management owing to the fluctuation in dividends caused by changes in earnings. The historic five-year average dividend payout rates of the Standard & Poor's (S&P) 500 Index are shown in Figure E3-2.

Record Request DTE-2

Please provide a copy of the GAAP standard applicable to the accounting for the stock dividend.

Response

Please see the discussion set forth in the FASB standard provided in response to RR-DTE-1.